STATE BOARD OF EQUALIZATION
STAFF LEGISLATIVE BILL ANALYSIS

Date Amended:	**05/11/00**	Bill No:	**AB 2077**
Tax:	**Sales and Use**	Author:	**Steinberg, et al.**
Board Position:	**Support**	Related Bills:	

BILL SUMMARY:

This bill would do the following:

1. Expand the 5 percent manufacturer's sales and use tax exemption to include establishments primarily engaged in commercial physical and biological research and development.
2. Allow qualifying persons engaged in biopharmaceutical research or biotechnology research and development activities to be regarded as a new trade or business until regulatory approval is received for any product from the United States Food and Drug Administration.

ANALYSIS:

Current Law:

Under existing law, Section 6377 of the Revenue and Taxation Code provides an exemption from the 5 percent *state* sales and use tax for purchases of equipment by manufacturers. Under the law, this partial exemption is available only to "qualified persons," which include only new trades or businesses that are engaged in those lines of business described in Standard Industrial Codes 2011 to 3999 (manufacturers). The partial exemption applies to the following:

- Tangible personal property to be used 50 percent or more in any any stage of manufacturing, processing, refining, recycling or fabricating (e.g., machinery, equipment belts, shafts, computers, software, pollution control equipment, buildings and foundations.)
- Tangible personal property purchased for use in research and development by a qualified person.
- Tangible personal property purchased to be used 50 percent or more in maintaining, repairing, measuring, or testing any exempt manufacturing equipment.
- Tangible personal property sold to or purchased by a contractor for use in the performance of a construction contract with a qualified person, as specified.

To qualify for the partial exemption under Section 6377, the purchaser must be a manufacturer as described in the specified codes of the Standard Industrial Classification (SIC) system and does not include any person who has conducted business activities in a new trade or business for three or more years. An establishment solely engaged in research and development activities, such as a biotechnology laboratory, is generally not regarded as a qualified manufacturer, since the manufacturing activities generally do not commence until after the establishment receives FDA approval to manufacture the product.

Under the existing Personal Income Tax Law and Bank and Corporation Tax Law, a state income tax credit of 6 percent of the cost of tangible personal property purchased by qualified taxpayers (generally, persons engaged in the business of manufacturing) for use in manufacturing, research and development, and various other related activities is allowed. SB 676 (Stats. 1994, Ch. 751) extended this 6 percent manufacturer's income tax credit to costs incurred with respect to tangible personal property and special purpose buildings and foundations by biopharmaceutical and biotechnology establishments.

In addition, under these laws, businesses may carry over net operating losses to future years. For most businesses, only 50% of the loss qualifies for carryover, and the carryover is limited to 5 years. However, for new businesses, as defined, 100% of operating losses may be carried over and the carryover period is increased to 8 years for losses incurred in the first years of business, 7 years for any losses incurred in the second year, and 6 years for any losses in the third year. SB 38 (Ch. 954, Stats. 1996) amended these net operating loss carryover provisions so that taxpayers engaged in biopharmaceutical activities or other biotechnology activities that are described in SIC codes 2833 to 2836 that have not received regulatory approval for any product from the U.S. Food and Drug Administration, will be regarded as a "new business" for purposes of those laws.

Proposed Law:

This bill would do the following:

- Define "qualified person" for purposes of the 5 percent sales and use tax exemption for purchases of tangible personal property by new manufacturing businesses to include establishments primarily engaged in the line of business described in Code 8731 of the Standard Industrial Classification Manual (commercial physical and biological research and development on a contract or fee basis).
- Specify that persons engaged in pharmaceutical and medicine manufacturing businesses that are described in Industry Group Code 3254 or Industry Code 54171 of the North American Industry Classification System Manual shall remain a "qualified person" until regulatory approval is received for any product from the United States Food and Drug Administration.

The provisions of the bill would become operative on the first day of the calendar quarter commencing more than 90 days after the bill is enacted.

COMMENTS:

1. **Sponsor and purpose of the bill.** This bill is sponsored by Advanced Medicine, a South San Francisco firm engaged in conducting medicinal research and development activities. According to the bill's sponsor, FDA approval for products can take up to 15 years, and the current manufacturer's exemption provisions do not provide any benefit to those start-up firms during the course of their research and development.

2. **The May 11, 2000 amendments make clarifying changes.** These amendments clarify that if a qualifying establishment merges with an establishment that has already received regulatory approval to make a product, then the qualifying establishment would no longer qualify for the partial exemption. The amendments further specify that, if a qualifying establishment merges with another qualifying establishment, and either has yet to receive regulatory approval to make a product, then the proposed exemption would continue to apply until such time that approval is received.

3. **Proposed exemption would not appear to apply to special purpose buildings and foundations.** It should be noted that, unlike the income tax credit, for purposes of this proposed sales and use tax exemption, purchases of materials and fixtures incorporated into special purpose buildings and foundations of these pharmaceutical and medicine establishments would not appear to qualify for the proposed partial exemption, since the applicable provisions of existing law limit the partial exemption to those facilities used during the manufacturing process or those facilities used as an integral part of the manufacturing, processing, refining, or fabricating process.

4. **Should the exemption for leased property be modified for these new establishments?** Subdivision (h) of existing Section 6377 limits the partial exemption for leased property to six years, so that a new manufacturer would not be required to pay tax on its rentals of qualifying property for a period of six years from the date the lease commences. The author may wish to extend the six-year period with respect to leased property acquired by pharmaceutical and medicine establishments in the course of their research and development activities.

5. **Should the sunset date be extended?** Existing Section 6377 has a sunset date for the partial exemption in subdivision (g) of January 1, 2001 or the next January 1 thereafter if certain employment figures are not reached. Should this sunset date be extended? At least one measure has been introduced this session to extend the sunset date for the manufacturers' income tax credit administered by the Franchise Tax Board (SB 2145, Knight, et al.).

6. **Bill would not be problematic to administer.** Because of the existing partial exemption that is extended to manufacturing industries and a similar partial exemption for the teleproduction and post production establishments, the Board has developed a system of approving claimed exemptions which should not materially be impacted with the enactment of this measure.

COST ESTIMATE:

Some costs would be incurred in notifying affected taxpayers, amending the applicable regulation, and approving claimed exemptions. These costs would be absorbable.

REVENUE ESTIMATE:

Background, Methodology, and Assumptions

The activities added to the lines of business qualifying for the new manufacturers' exemption are those described in Standard Industrial Classification Code 8731 – Commercial Physical and Biological Research. Although other portions of this bill limit coverage to the areas of pharmaceuticals and medicines, the basic qualification for the new manufacturers exemption is extended to any physical and biological research activity, not just research in pharmaceuticals or medicines.

The 1992 Census of Service Industries showed total capital expenditures (excluding land, buildings, structures, and related facilities) of $1,421,000,000 for all establishments in SIC industry group 873 - Research, Development, and Testing Services. Based on the reported receipts of those establishments we estimate that the capital expenditures for California establishments engaged in Code 8731 activity were $131,875,000 in 1997. A 5 percent tax rate applied to $131.875 million of expenditures would produce $6.6 million in tax. Although there are no data that identify the portion of the above amounts attributable to new businesses, that portion is likely to be quite small. (This would be consistent with the Board's experience with the sales tax exemption for new manufacturers enacted in 1993.) If one assumes that new businesses comprise only 1 percent of the above amounts, a 5 percent tax exemption for them would result in a $66,000 tax reduction.

This bill also extends the definition of "new" beyond 3 years for pharmaceutical and medicine manufacturing businesses that are described in North American Industry Classification System (NAICS) industry group code 3254 (Pharmaceutical and Medicine Manufacturing) and industry code 54171 (Research and Development in the Physical, Engineering, and Life Sciences), until regulatory approval is received for any product from the United States Food and Drug Administration. This would mean that once a firm receives its first regulatory approval for any drug, it would no longer be considered new.

The 1997 Census of Manufacturing showed total capital expenditures of $601,491,000 for California establishments in NAICS code 3254. Based on the 1996 Annual Survey of Manufacturers we estimate that $495,629,000 of that amount is for machinery and equipment. A 5 percent tax rate applied to the $495.629 million of expenditures would produce $24.8 million in tax. At least on the surface it appears that this portion of the bill does not cover any of this amount, since being a "manufacturer" would imply that the firm has received regulatory approval for at least one product. That would limit the

effect of this portion of the bill to certain NAICS code 54171 establishments. NAICS code 54171 includes all SIC code 8731 firms, as well as firms in some other SIC codes. However, this portion of the bill pertains only to NAICS code 54171 firms dealing with pharmaceuticals and medicines.

Considering both parts of the bill, we estimate that the total intended effect of the bill could exceed $100,000 but would probably not be as large as $500,000.

Revenue Summary

It is estimated that exempting the capital expenditures of the firms that appear to be covered by this bill from the 5 percent State General Fund tax rate would reduce sales and use tax revenues by $100,000 - $500,000, annually.

Analysis prepared by:	Sheila T. Sarem	445-6579	05/18/00
Revenue estimate by:	David E. Hayes	445-0840	
Contact:	Margaret S. Shedd	322-2376	

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